TAX FACTS

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Looking More Closely: Who Really Pays Illinois Taxes?

By Mike Klemens

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When it comes to taxes, many American think they pay too much. However, in the increasingly complex world of taxation it is often hard to know how much one does pay. For a tax like the personal income tax the answer is relatively straightforward – just check the "total tax" line on your 1040 return to see what you paid. For a host of other taxes, those imposed initially on business, the impact shows up not as a line on a tax return, but as higher prices or lower earnings.

Legal incidence vs economic incidence: Who really pays?

In terms of "who pays" there is a significant distinction between "legal incidence," who is legally responsible for a tax, and "economic incidence," who ultimately pays the tax. As one of my favorite public finance economists used to tell me, over and over, "Mike, businesses don't pay taxes, people pay taxes."

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

In this edition of *Tax Facts* we attempt to tackle the issue of tax incidence – the question of **who ultimately pays** various taxes. The article highlights the distinction between "legal incidence" – who the tax is imposed on – and "economic incidence" -- who ultimately pays the tax. The second article looks at the taxation of recreational marijuana, and attempts to set reasonable expectations for what such a tax could raise.

A significant portion of taxes initially imposed on business are ultimately borne by consumers in the form of higher prices and by workers in the form of lower wages. We have neither the data nor the resources to conduct an Illinois-specific tax incidence study, so we review the study conducted by the Minnesota Department of Revenue. Then, to get to an order of magnitude for Illinois, we pretend that Illinois is Minnesota – keeping in mind that of course it is not – and apply the findings of the Minnesota study to Illinois. This is a good reminder for those seeking to increase business taxes, and those complaining that the business tax burden is too high: the ultimate payors of the tax are usually customers and employees, not the business itself or even its owners.

The **recreational marijuana** article does not mean that TFI is championing legalization of recreational marijuana; we are merely trying to put some dollars and cents behind the proposals to do so. We look at the four states that have legalized recreational marijuana and legislation introduced in Illinois to estimate the tax revenue it would generate. Not surprisingly, the range is wide. (And, in case you were wondering, it would not solve our budget woes.)

One final note: this is TFI's 75th anniversary year. We are looking forward to celebrating that anniversary at our 75th annual meeting this June with our many members and friends. I hope you can join us!

An example of the hidden shift of tax burden from one party to another would be Illinois' 6.25 percent sales tax (technically the Illinois Retailer's Occupation Tax). When you buy something in Illinois, the legal incidence of the sales tax falls on the retailer who sells the product to you and who must file the state tax return with and pay the tax to the state. However, the retailer is allowed to add the tax to your bill and collect the tax from you, so that you bear the economic incidence.

It gets more complicated when the purchase is by a business. Take a local delivery service that has a van break down that has to be replaced. The legal incidence of the tax on the new truck remains with the truck dealer who sells the truck, but the truck dealer just adds the tax to the price of the truck and collects both from the delivery service.

The delivery service owner has several choices. She might raise the rate she charges, as long as she's not in a competitive environment where a rate increase would cause her to lose business, in which case the economic incidence would be on her customers. Or, she might say to her drivers, "Sorry but I am going to have to delay giving you a raise this year because we had to buy a new truck," in which case the economic incidence would be on her employees. Or the delivery service owner might say "I'll just make less money this year," in which case the economic incidence would be on the owner herself.

Determining tax incidence gets even more complicated when dealing with large multi-state businesses whose customers, employees, and owners are scattered across the country, allowing a state to "export" tax to non-resident consumers, employees, and business owners.

<u>Seeking an answer:</u> ***<u>The Minnesota Tax Incidence Study</u>***

An example of a detailed effort to measure economic incidence is contained in a biennial study done by the Minnesota Department of Revenue for Minnesota state and local taxes. The report is statutorily mandated and its stated purpose is to measure the impact of taxes on households of various incomes to allow policy makers and the public to track the fairness of taxation.

The Texas Comptroller of Public Accounts also examines tax incidence in a section of its annual Tax Exemptions & Tax Incidence report, which is more limited than the Minnesota study and acknowledges the contributions made by the Minnesota Study.

For the 2015 Minnesota study (which covered 2012), researchers drew a stratified random sample of 109,597 Minnesota households. They used information from federal and state income tax returns, from property tax refund returns, other state agencies, the Census Bureau and the U.S. Department of Labor's Consumer Expenditure Survey. And they project forward five years, to judge what tax incidence will be in 2017. The study is focused on Minnesota households, which it divides into 10 equal groups (deciles) from high to low in terms of income

For many taxes the calculation is pretty straightforward, particularly those paid directly by individuals. The legal incidence of the personal income tax is on the individual; the economic incidence will be on Minnesota households, except for the tax paid by non-residents who earn income and pay tax in Minnesota. Sales tax on consumer goods is similar. The customer who buys something pays the tax, making the economic incidence Minnesota households, except in the case of tourists and other visitors.

On the business side, tax incidence is far more complex. As described in our example above, tax can be reflected in a lower profit for the business owners (in and out of Minnesota), higher prices for its customers (in and out of Minnesota), and lower wages for its workers, or some combination of the three.

To estimate taxation on different households, the Minnesota researchers have to deal with the difference between legal incidence and economic incidence and to determine the extent to which taxes imposed on businesses are shifted to Minnesota households and how much are exported to consumers or business owners in other states. Their assumptions are listed in the sidebar on page 6.

Overall, the Minnesota study finds that the legal incidence of state and local taxes was 63.1 percent on Minnesota residents, while the economic incidence was 82.7 percent on Minnesota residents (the balance was exported to non-resident consumers and non-resident owners). In other words, approximately half of those taxes legally incident on businesses were shifted onto Minnesota households.

The Minnesota study assumes that the extent of shifting taxes depends on both the tax rate compared to the rest of the country and on the market the business serves. The study finds that to the extent that Minnesota's rate of taxation is below average, the incidence will be borne by the customer because prices can be raised. To the extent that the rate is above average, the tax will be borne by labor and by the business owner.

The study also takes into account the market for the goods. If the business is competing only with other Minnesota businesses for sales, all businesses face the same tax burden and can raise prices charged customers, so the burden will be borne by consumers.

The specific tax breakdown from the Minnesota study is as follows:

<u>State Corporation Franchise Tax (comparable to the Illinois Corporate Income Tax)</u>

41 percent – exported

59 percent – borne inside Minnesota, of which

- 0 percent is imposed directly on Minnesota households
- 72 percent is shifted to Minnesota consumers through higher prices,
- 20 percent is shifted to Minnesota workers through reduced wages, and
- 8 percent is borne by Minnesota business owners.

<u>State and Local General Sales and Use Tax</u>

21 percent – exported

79 percent – borne inside Minnesota, of which

- 66 percent is imposed directly on Minnesota households,
- 31 percent is shifted to Minnesota consumers through higher prices,
- 0 percent is shifted to Minnesota workers through reduced wages, and
- 3 percent is borne by Minnesota business owners.

<u>Commercial Property Tax</u>

48 percent – exported

52 percent – borne inside Minnesota, of which

- 0 percent is imposed directly on Minnesota households,
- 63 percent is shifted to Minnesota consumers through higher prices,
- 5 percent is shifted to Minnesota workers through reduced wages, and
- 32 percent is borne by Minnesota business owners,

<u>Industrial Property Tax</u>

83 percent – exported

17 percent – borne inside Minnesota, of which

- 0 percent is imposed directly on Minnesota households,
- 31 percent is shifted to Minnesota consumers through higher prices,
- 25 percent is shifted to Minnesota workers through reduced wages, and
- 44 percent is borne by Minnesota business owners

As outlined above, the Minnesota study is based on very specific data from that state, and its results cannot be directly applied to other states. For example, Illinois is more reliant on the property tax, less reliant on the income tax, and has lower taxes overall than does Minnesota. Nevertheless, let's incorrectly assume that Minnesota's study would work for Illinois to get an idea of the magnitude of the shift involved.

If Illinois were Minnesota **(which it is not)**:

Illinois' corporate income tax (including the Personal Property Replacement Income Tax) of $4.74 billion in FY 2015 would have been borne as follows:

- $2.02 billion in higher prices to Illinois consumers,
- $0.56 billion in reduced wages to Illinois workers, and
- $0.22 billion in reduced profits to Illinois business owners.

Another $1.93 billion would have been exported to business owners and consumers outside Illinois.

For Illinois state sales tax (the 6.25 percent rate) of $10.91 billion in FY 2015 would have been borne as follows:

- $5.68 billion paid directly by Illinois consumers,
- $2.67 billion in taxes initially on business shifted to Illinois consumers in higher prices, and
- $0.32 billion in reduced profits to Illinois business owners.

Another $2.30 billion would have been exported to business owners and consumers outside Illinois.

For Illinois commercial property taxes of $6.65 billion paid in 2015, the burden on the property owner would have been borne as follows:

- $2.17 billion in higher prices to Illinois consumers
- $0.17 billion in reduced wages to Illinois workers, and
- $1.10 billion in reduced profits to Illinois business owners.

Another $3.20 billion would have been exported to business owners and consumers outside Illinois.

The Minnesota researchers emphasize that their study measures the economic incidence of business taxes as they existed at the time of the study, but cannot be applied to any tax increases, because business activity has adjusted over time to the current levels and relationships. The study makes the point directly: "The incidence results reported here cannot be applied to proposals for business tax changes." As a general rule the researchers say that the economic incidence of an increase in Minnesota taxes would fall most heavily on Minnesota consumers and workers.

Conclusion

Economic incidence matters for a couple of reasons:

First, arguments that a proposed tax is being paid by businesses, not individuals are flat out wrong. The Minnesota study attempts to quantify the significant portion of what would otherwise be classified as business taxes that ultimately come out of the pockets of Minnesota households and workers.

Second, the numerous studies that purport to measure business tax burden represent only the first step in an analysis, unless they include an effort to distinguish between legal and economic incidence.

Nobody said taxes were simple.

Assumptions in the Minnesota Tax Incidence Study

The study uses six principles to estimate the economic incidence of Minnesota business taxes:

1. Capital moves where it earns the highest return.
2. Minnesota does not impose business taxes in isolation, so the analysis considers Minnesota's tax rates relative to those in other states.
3. Businesses, consumers, and workers have adjusted to differences in existing taxes.
4. Some businesses can shift business taxes onto customers in the form of higher prices, if their product competes in a Minnesota market where their competitors must pay the same taxes.
5. Taxes are borne by immobile resources, in this case by land and workers.
6. Overall, workers do not move between states because of tax changes; because higher taxes mean higher government expenditures, net benefits to Minnesota residents are unchanged, removing any incentive to relocate. (Naturally individual workers may value low taxes over higher government services, and vice versa.)

Legalization of Recreational Marijuana

By Dr. Natalie Davila and Maurice Scholten

Natalie Davila is an economist with an extensive background in public finance. She was Director of Research for the Illinois Department of Revenue for 10 years.

Maurice Scholten joined the Taxpayers' Federation of Illinois in January 2015 as Legislative Director. Before joining TFI, he was Senior Legal Counsel for the Senate President's Office where he worked on taxes, pensions, workers' compensation and unemployment insurance.

From time to time, people suggest that Illinois should legalize and tax recreational marijuana, and one of the supporting augments is that the tax revenue could help with our budget woes. In this article, we look at existing state tax regimes and attempt to estimate how Illinois would fare. At the time of writing, four states have legalized the purchase of marijuana for recreational use: Alaska, Colorado, Oregon and Washington.

Alaska:

Alaska levies a $50 per ounce excise tax on the sale of marijuana from the cultivation facility to the retail store. Alaska does not have a state sales tax, however localities have the option of enacting local sales taxes (0-7.5%). In Alaska, state analysts estimate tax revenue from marijuana sales will range from $5.1 million to $19.2 million. Alaska is currently in the process of issuing the proper licenses to cultivators, retailers and others. As a result, marijuana will not be legally sold until September 2016 at the earliest.[1]

[1] https://www.commerce.alaska.gov/web/amco/MarijuanaInitiativeFAQs.aspx

Colorado

Colorado has a 15 percent excise tax on the average market price of retail marijuana. The tax is imposed on the first transfer of marijuana from the cultivation facility to the retail store. The state of Colorado posts this average market price twice a year. Recreational marijuana is subject to a 2.9 percent sales tax, plus an additional 10 percent state sales tax – for a total minimum rate of 27.9 percent. Locals may impose additional taxes. Currently Colorado is bringing in $11 million per month in combined state sales and excise marijuana tax revenue.

Based on the most recent data from Colorado and adjusting for Illinois' greater population, if Illinois adopted Colorado's tax structure the state would receive estimated annual revenue of some $321.5 million. Note that this estimate allows for an exemption for growing cannabis at home.

	Colorado	Illinois
Retail Market Size	$488,917,204	$1,152,274,816
Tax Revenue	$136,407,900	$321,484,674

Oregon

Currently, recreational marijuana is sold in medical dispensaries and the state imposes a sales tax of 25 percent with locals able to add up to an additional 3 percent. In 2017, there will be stores that just sell recreational marijuana, and the state's rate will be lowered to 17 percent. Locals will again be able to levy an additional 3 percent. Oregon does not levy an excise tax on wholesale-level marijuana transactions.

At the time of writing, only one month of actual data is available for Oregon. In the first month, marijuana tax collections were $3.5 million. Extrapolating this one month of data out for a full year and adjusting for Illinois population, under the Oregon tax structure Illinois could generate $134 million in annual marijuana tax revenue. Note that this estimate allows for an exemption for growing cannabis at home.

	Oregon	Illinois
Retail Market Size	$168,000,000	$536,235,168
Tax Revenue	$42,000,000	$134,058,792

Washington

Washington levies a 37 percent excise tax on marijuana paid by the consumer. The regular sales tax also applies. The State sales tax rate is 6.5 percent and local rates are as much as 3 percent. Currently state marijuana sales tax collections are averaging $2.4 million per month. Extrapolating Washington marijuana sales and excise tax revenue to Illinois based on population yields annual revenue of $306.4 million. Note that this estimate does not allow an exemption for growing cannabis at home.

	Washington	Illinois
Retail Market Size	$392,722,621	$704,346,404
Tax Revenue	$170,834,340	$306,390,686

Illinois Legislative Proposal

At the time of writing, only one bill is currently pending before the Illinois General Assembly that would legalize recreational marijuana, so here we evaluate the tax components of that specific bill. There have been other proposals in the past, and likely will be more in the future, but this provides the best available starting point for estimating Illinois' potential revenue. Illinois HB 4276 proposes a tax structure where the general sales tax rate along with a 10 percent excise tax would be applied. The sales tax would be applied to the retail price while the excise tax would be on the wholesale price. Note that this proposed taxing structure would put less of a tax burden on marijuana in Illinois compared with the four states that have currently legalized marijuana.

The above estimates for the Illinois marijuana market size based on other states' recent experiences vary widely, ranging from $536.2 million to $1,152.3 million.

Applying the tax structure proposed in HB 4276 (5 percent state sales tax rate along with 10 percent excise tax rate) to our estimates of Illinois market size (assuming a 100 percent retail mark-up, so the excise tax base—the wholesale price—is one-half the retail market amount) yields an annual state revenue estimate ranging between $53.6 million and $115.2 million.

Retail Market Size	Excise Tax (10%)*	Sales Tax (5%)	Total Annual Revenue
$1,152,274,816	$57,613,741	$57,613,741	$115,227,482
$704,346,404	$35,217,320	$35,217,320	$70,434,640
$536,235,168	$26,811,758	$26,811,758	$53,623,517
* assumes 100 percent retail mark-up			

Forecast Risks

Our first observation is that the range of the revenue estimate is huge and is for a period after the tax administration is fully operational and the revenue should not be anticipated immediately. The wide range arises because of the great uncertainty about the size of Illinois' market for marijuana along with what will happen to prices should legalization occur. It is unclear how consumers will respond to changes in price – relative to the black market - that occur should the state begin to tax marijuana. Some (unknown amount) of consumers may still chose to buy on the black market and thus exert downward pressure on the estimate.

In addition, unless there is a price floor (an amount set in law below which the price of marijuana could not fall) increases in the supply or demand would impact the estimate. On the supply side, an increase in supply would exert downward pressure on the price. On the demand side, an increase in demand would exert upward pressure on the price. Should both of these occur, the change in price would depend on the relative magnitude of changes in demand compared with changes in supply. If the supply changes are greater than demand changes a fall in price would occur and result in declining revenues.

As noted in our revenue estimates, the legal ability for individuals to grow their own marijuana on a small scale could have a significant impact on the size of the retail marijuana market. Colorado and Oregon each allow individuals to grow up to six marijuana plants per person for non-medical purposes. HB 4276 allows an individuals to grow up to eight marijuana plants. Our estimates based on Oregon and Colorado data reflect the ability in those states to grow some marijuana for personal use, while the estimate based on Washington data reflect the prohibition on home growing.

Illinois Tax Facts

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Another potential unknown revenue impact of marijuana legalization is the extent to which it would decrease revenue raised by alcohol excise taxes. There is some evidence that marijuana consumption functions as a substitute to alcohol consumption, which means that the revenue raised by alcohol excise taxes could potentially decrease if marijuana is legalized and people begin to consume more marijuana and less alcohol as a result.

Conclusion

Given the highly unpredictable nature of marijuana legalization any estimates of the amount of revenue that marijuana taxes could raise should be viewed as ballpark figures rather than precise forecasts.

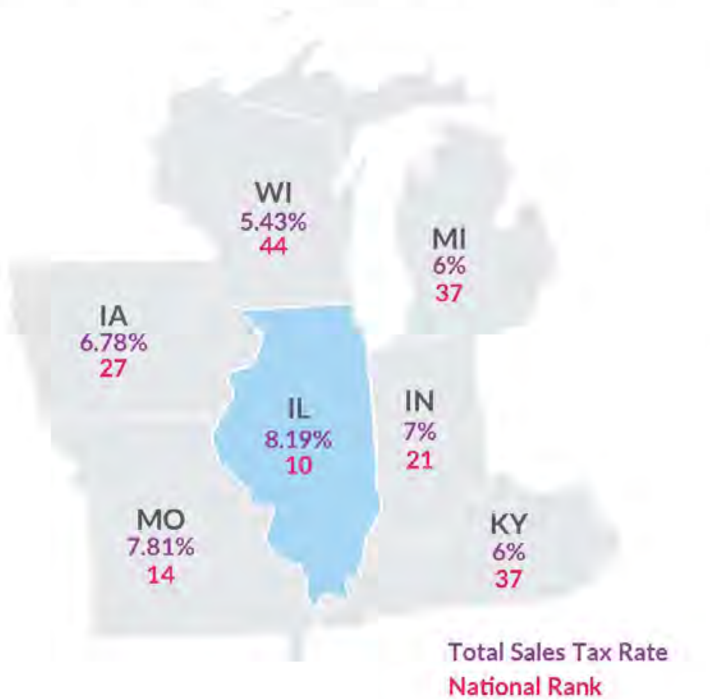
One main take away from this analysis is that any estimate on how much revenue would be generated in Illinois is subject to a wide margin of error. In terms of budgeting, this revenue source should not be part of the general fund at least until a history of how much revenue will be generated on an annual basis.

More pages from Illinois Illustrated

Last year, the Taxpayers' Federation of Illinois, through our affiliate, the Illinois Fiscal Policy Council, and the Tax Foundation jointly published the chartbook *Illinois Illustrated*. The user-friendly charts and graphs in the book, including those on these pages, were a big hit with many of our friends and members. The book in its entirety is available on both groups' websites: iltaxwatch.org and taxfoundation.org. Or contact TFI if you would like a hard copy.

Illinois Has the Highest Combined Average Sales Tax Rate among Its Neighbors

Combined State and Average Local Sales Tax Rates, Illinois and Neighbors (as of July 1, 2014)

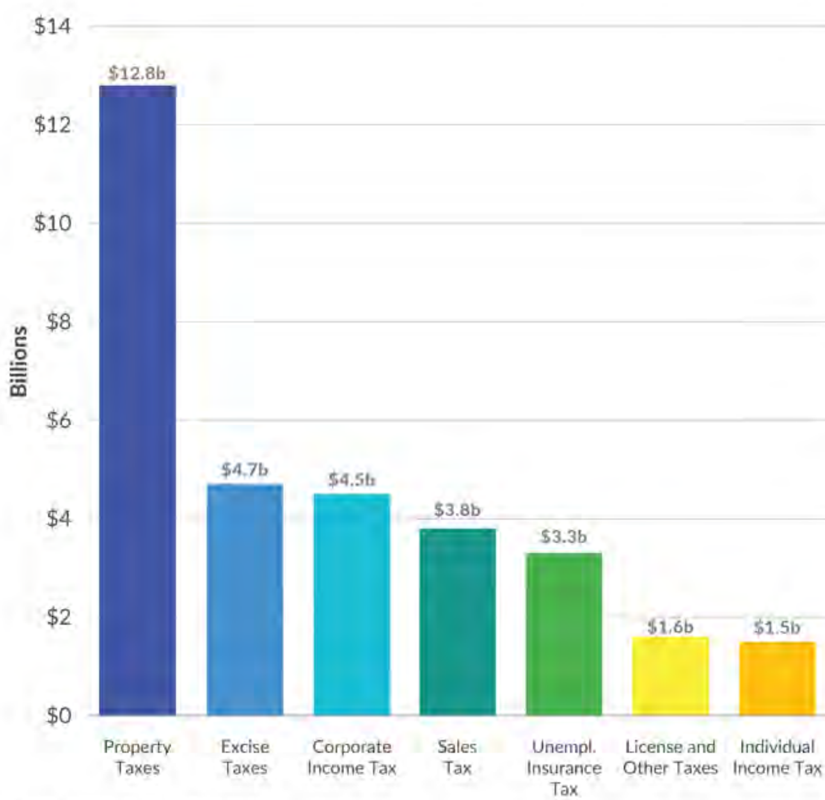


Sales taxes in most states are levied at both the state and local levels. Illinois' state-level rate (6.25 percent), which is already high compared to other states, is made higher by the additional local taxes that are tacked on top.

When both are considered, Illinois has the highest combined average rate among its neighbors and the 10th highest rate in the country. Local sales taxes, on average, amount to 1.94 percent. Indiana, Kentucky, and Michigan do not levy local sales taxes.

Businesses Don't Just Pay Corporate Income Taxes

Illinois' Total State and Local Business Tax Liability by Tax Type (FY 2013)



A common misconception is that corporate income taxes are the only tax cost for businesses. However, businesses pay a number of other taxes, including property taxes on real estate, sales taxes on the goods they use, and individual income taxes on business income (if they're pass-through entities that file through the individual income tax code rather than the corporate income tax code).

Overall, Illinois businesses paid $32.3 billion in taxes in 2013, with the largest portion going to property taxes.

Source: Council on State Taxation and Ernst & Young LLP, *Total state and local business taxes (FY 2013)*.

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